

NEWSLETTER



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No. 19, March 2005

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What Are the Compliance Costs of Taxation in Croatia for Businesses?¹

Between June 2001 and June 2002 the corporate sector in Croatia spent more than 2 billion kuna on taxation compliance activities, which amounts to about 1.2% of GDP.

The Institute of Public Finance tried to assess the total costs of taxing companies, defined as entities liable to pay profit tax². The total compliance costs of the taxation of companies are the part of the costs that a corporate entity has to bear to comply with the demands set by the law and the revenue authorities, and that surpasses the actual amount of tax that is paid. According to kind of tax, all the taxes apart from customs duty and excise duty were analysed – profit tax (or corporate income tax), VAT, wage taxes, contributions for social insurance and other taxes. According to kind of cost, an analysis was made of the costs of labour charged with tax matters within the company, costs inside the company that do not relate to labour (additional software and hardware, forms and office materials, postage,

telephones, professional literature, seminars, travel and court costs) and external costs (independent accounting, tax advisers and the like).

The total annual compliance costs of companies that pay profit tax in Croatia from June 2001 to June 2002 came to a sum equivalent to 1.2% of GDP. Of this amount, a third of all costs were borne by companies with two employees at the most, including the owner of the company. It is significant that with the increasing size of the company, the compliance costs of profit tax fall, the costs of VAT compliance rise, while the proportion represented by wages tax is constant. As far as the effectiveness of tax is concerned, defined as the percentage of the tax compliance costs in the relevant tax revenue, profit tax is the least effective (11.8%), while VAT and wage tax, which amount to 4.5% and 2.9% of the relevant revenues respectively, are relatively effective. The 11.8% proportion of profit tax means that a company that pays one kuna of profit tax also pays an additional 11.8 lipa in the sheer act of com-

¹ This Newsletter was written according to the article Blažić, H., 2004. "Compliance Costs of Business Taxes: Business Units that Pay Corporate Income Tax", *Financijska teorija i praksa* 3/04, Institute of Public Finance, available at the URL: <http://www.ijf.hr/eng/finpraksa/2004/3-04.html#2>. The author thanks Helena Blazic for permission to use this article.

² Companies here are taken to include both companies and establishments that are liable to pay profit tax.

The Institute of Public Finance deals with economic research and analysis related to various forms of public finances such as the budget, taxation and customs duties. Its orientation is thus to the various economic, legal and institutional topics that are important for the sound long-term economic development of the Republic of Croatia. So that the public should be able to have a better insight into certain issues, the Institute of Public Finance is launching its Newsletter, in which it will from time to time publish informed and independent analysis of economic questions. The views expressed in the articles published in the Newsletter will reflect the opinions of the authors, which do not necessarily coincide with those of the Institute as institution. Full text of Newsletter is also available on Institute's Web site: <http://www.ijf.hr/newsletter>.

Table 1. Average costs of tax compliance in companies (in kuna)

Number of employees, excluding proprietors	Average total costs	Average costs per employee, excluding proprietors	Average costs per unit of profit*	Average costs per unit of revenue
up to 2	19,824	16,641	0.7421	0.0402
3-5	30,217	8,033	0.4159	0.0283
6-20	45,063	4,715	0.1844	0.0105
21-250	80,686	1,168	0.1198	0.0047
more than 250	120,130	267	0.0183	0.0009
total	27,112	9,988	0.5861	0.0321

* Only for companies that do make a profit.

pliance with this tax liability (some of this is the time spent by the owner of the company). Similar comments can be made about the other proportions.

The average of overall and unit costs of the taxation of companies according to number of employees is displayed in Table 1.

From Table 1 it can be seen that the average costs rise with an increase in the size of the company. The overall costs, measured per employee, units of profit and units of revenue, are regressive. The regressive effect of the costs of corporate taxation is also seen, visible in the fact that these costs lie relatively more heavily upon small companies. The costs of taxation compliance per employee in the smallest companies are 62 times as great as in the largest companies that have 250 employees or more. Taxation compliance costs per unit of profit are 40 times greater for small companies, and the costs per unit of revenue are 45 times greater.

Taxation compliance costs according to kind of cost

The proportion of proprietors or managers of companies that deals with taxes reduces in all size classes, except in the last. The larger the company, the more proprietors and managers take an active part with other persons inside and outside the companies. On the other hand, though, with a rise in the size of the company, the proportion of unpaid assistance tends to drop. As far as the proportion of proprietor's time costs are concerned, they tend to fall with the rising size of the company. The trend is

completely opposite for costs related to other employees who deal with tax matters, with their proportion constantly rising.

The proportion of independent costs at first rises rapidly because many proprietors in the second size class outsource their tax and accountancy matters. After that, the proportion falls, because an increasing number of accountants are employed in-house, to deal with numerous daily accountancy and tax matters. This is the main reason why the share of these costs is very low in companies with more than 250 employees. In such companies the whole matter of accountancy and taxation is done in-house, while independent sources are mainly used for the specialised services of tax advising.

Table 2 displays costs of tax compliance at the macro-level and the effectiveness of the tax.

As mentioned, the smallest companies with up to two employees bear a third of all the compliance costs of taxation. These companies, constitute 60% of all corporate entities. Furthermore, more than a half of the overall costs of taxation are borne by companies with five employees at the most. Such companies amount to almost 80% of the corporate sector. The largest companies, with more than 250 employees, account for a very small proportion of the compliance costs, only 2.4%, which primarily reflects the fact that there are so few of them. Of the companies that were analysed in this research, there were only 419 large ones, or 0.5%.

VAT is the most expensive tax. It is followed by wage tax, wage contributions and profit tax. The proportion of the compliance costs of profit tax decreases (with growing size of the company)

Table 2. Compliance costs of taxation borne by companies from June 2001 to June 2002 according to kind of tax and size of entity (in millions of kuna and in %)

Number of employees	Compliance costs for all taxes (in million kuna)	Structure of all the tax compliance costs under review (%)	Compliance costs of profit tax (%)	VAT compliance costs (%)	Compliance costs of wage taxes and wage contributions* (%)	Compliance costs of other taxes (%)
up to 2	760,39	37.30	24.15	42.43	23.67	9.75
3-5	431,69	21.18	18.85	46.75	28.35	6.05
6-20	472,85	23.19	20.40	46.86	24.14	8.60
21-250	324,92	15.94	10.59	55.96	27.88	5.59
>250	48,75	2.39	10.49	65.01	22.00	2.50
total (in %)	–	100.00	19.31	47.49	25.34	7.86
(in million kuna)	2.038,60	–	393,65	968,13	516,58	160,23

* Tax on income on the pay of employees, not including the proprietors of the companies, local surtax and contributions for social insurance.

because of the important fixed element of this tax. On the other hand, the proportion of VAT compliance costs increases because of the rise in turnover and the delivery of goods and services. The proportion of the costs of wage taxes and contributions for social insurance remains more or less a constant.

Effectiveness of taxes

The effectiveness of a tax is usually measured by their costs expressed as a percentage of the relevant tax revenues. For companies that are liable to pay profit tax this percentage amounts to 11.8%, which is higher than relative compliance costs of other taxes. Reasons for this include the constant rise of the proportion, the introduction of numerous tax incentives, the relatively low rate of tax on profit and the fact that almost half of the companies operate at a loss.

The compliance costs for VAT borne by VAT registered entities expressed as a percentage of VAT revenue come to about 4.5%. This is strong evidence of the relative effectiveness of this tax at the

corporate level. In spite of this, it is worth pointing out that this relatively low proportion is affected by the relatively high standard rate of VAT, 22%, without any reduced rates and with a very limited (rare) implementation of the zero rate.

On the basis of the number of employees in the sector analysed, a rough estimate of the profit paying entities' compliance costs of wage taxes and social security contributions as a percentage of the total revenue of these taxes (resulting in the effectiveness of wage taxes) was made, and it amounted to 2.4%.

Finally, it may be said that the overall taxation compliance costs of entities liable to pay profit tax expressed as a percentage of GDP is, at 1.2%, not particularly high. Neither are the proportions of the costs of the different taxes in the relevant tax revenues (taking into consideration corresponding researches in other countries). In other words, this means that the effectiveness of different kinds of tax analysed is relatively reasonable. But it would certainly be necessary, among other improvements of the tax system, to work on the simplification of the taxation system and harmonise the taxation and accounting systems more effectively.

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TISKANICA

No. 20, March 2005

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What Are the Compliance Costs of Taxation in Croatia for Small Businesses?¹

In Croatia, between June 2001 and June 2002, small businesses, defined as business units that pay personal income tax, spent 1.4 billion kuna on tax compliance costs, the equivalent of 0.8% of GDP.

The tax compliance costs of small businesses, defined as business units that pay personal income tax, referred to below as tradesmen (including women) are constituted by that part of the costs that tradesmen have to bear in order to comply with the demands made on them by the law and the tax authorities, and that surpasses the amount of tax actually paid. These costs of taxation consist of the time of the tradesman, unpaid assistance, the costs of labour employed in the small business, etc (see Table 3). The total annual compliance costs of tradesmen (who pay income tax) in Croatia from June 2001 to June 2002 amounted to the equivalent of 0.8% of GDP. During this period the tradesmen spent about 1.4 billion kuna in order to meet their tax liabilities. Apart from the high costs paid by the

tradesmen, the greatest reason for concern was the fact that more than three quarters of all costs were borne by the smallest small businesses, those with two to three employees, not including the registered tradesman or proprietor.

Effectiveness of the tax. Effectiveness is usually measured as the percentage of tax costs in the relevant tax revenues. The compliance costs of tradesmen's income tax expressed as a percentage in the total revenue collected from tradesmen (the effectiveness of income tax) is exceptionally high, which means that the tax is very ineffective. In order to pay one kuna of income tax, a tradesman has to spend between 65 lipa and one kuna on his compliance costs. By way of explanation, the average yearly revenue from tradesmen's income tax comes to 437 million, which is only slightly higher than the compliance costs incurred by the tradesmen (which add up to almost 98% of that amount). This means that the tradesmen spent practically the same amount to meet the costs of complying with their

¹ This Newsletter is written according to an article by Blažić, H., 2004. "Costs of Taxation of Business that Are Liable to Pay Income Tax", *Financijska teorija i praksa* 3/04, Institute of Public Finance, Zagreb. <http://www.ijf.hr/eng/finpraksa/2004/3-04.html#2>. The present author would like to thank Helena Blazic for permission to use this article.² Companies here are taken to include both companies and establishments that are liable to pay profit tax.

Table 1. Total annual costs of tax compliance incurred by tradesmen from June 2001 to June 2002 according to kind of tax and size of the business.

Number of employees	Compliance costs of all taxes (in million kuna)	Structure of all compliance costs under consideration (%)	Income tax compliance costs* (%)	VAT compliance costs (%)	Wages tax and contributions compliance costs** (%)	Compliance costs of other taxes (%)
0	503.68	36.79	40.44	29.94	8.87	20.75
1-2	550.84	40.24	27.00	26.88	31.81	14.31
3-5	176.25	12.87	21.77	43.64	27.24	7.35
≥ 6	138.24	10.10	23.35	38.49	26.94	11.22
total (in %)	–	100.00	31.39	31.02	21.86	15.73
(in million kuna)	1,369.00	–	429.73	424.66	299.26	215.34

* Tax on the tradesman's income.

** Tax on the incomes of employees, excluding the proprietor's income, local surtaxes and social security contributions.

tax liabilities, as the whole revenue generated from small businesses' income tax that flowed into the government's coffers in the same period. However, one should also bear in mind the fact that a large part of the costs of tax compliance for tradesmen consists of time spent (according to their own estimation). The gross costs of VAT compliance expressed as a percentage of revenue brought in by VAT are smaller, coming to about 24.3% (from 16 to 25%). This means that VAT effectiveness is greater than that of small business income tax.

Furthermore, the compliance costs paid by tradesmen in Croatia have proved to be regressive, which means that proportionally greater costs during taxation compliance are paid by those who are least capable of paying, that is the smallest small businesses or trades. The structure of compliance costs of tradesmen is dominated by the cost of the time, particularly the time of the proprietor of the trade. All these facts are the outcome of the research into the compliance costs of small business that pay income tax carried out by the Institute of Public Finance. The analysis covered not only tradesmen but also freelance professions and others that are treated in the same way as tradesmen. But in order to obtain a complete picture, the following table should be consulted.

More than three quarters of all tradesmen's compliance costs are borne by the smallest trades with two employees at the most first two classes. In the

structure of costs according to kind of tax, VAT is dominant, and then comes income tax (about 31%). If the costs structure of only those tradesmen that are VAT-registered (36% are outside the system) is taken into consideration then VAT is the most important, at 36.9%. After VAT come income tax (28.6%), and taxes on wages and social security contributions (22%). It is notable that in the third size class (3 to 5 employees) in which there are almost no exceptions to VAT payment, the proportion of VAT related compliance costs rises considerably.

The percentage of income tax compliance costs incurred by tradesmen is high (31%), particularly for the smallest trades, which are rarely in the VAT system and have few or no employees. For the same

Table 2. Average costs of employment per employee (in thousand kuna)

Number of employees* (excluding the proprietor)	Average costs per employee (excluding the proprietor)	Average costs per employee (including the proprietor)
1-2	12.9	10.0
3-5	6.0	4.8
6 and over	4.6	2.7
total	10.3	7.7

* Small businesses with no employees excluded.

Table 3. A full picture of the structure of total compliance costs of the taxation of tradesmen according to kind of cost

Number of employees not including proprietor	Proprietor	Unpaid assistance	In-house accountant	Other internal costs (not relating to labour)	Outsourced accountancy	Total
0	61.54	8.12	1.62	19.59	9.13	100
1-2	66.20	6.08	9.74	10.51	7.48	100
3-5	47.51	4.83	27.50	9.84	10.31	100
≥ 6	48.55	6.37	17.70	15.55	11.88	100
total (u %)	60.52	6.94	8.34	15.28	8.89	100

reason the costs of compliance with wage taxes and social insurance contributions are, as could be expected, small.

The compliance costs of tradesmen are regressive when measured as the costs of compliance per employee, per total size of the labour force including the proprietor and cost per employee.

The table shows that higher costs per employee (including or excluding the proprietor) are indeed borne by the smallest tradesmen, and that the compliance costs are smaller the larger the business. As the smallest tradesmen bear a proportionally larger share of the costs, the compliance costs of the tax are clearly regressive in their effect. The costs per employee in small businesses with one or two employees are three times greater than in businesses with six or more employees.

Internal labour costs are the most important part of the costs borne by tradesmen while complying with their tax liabilities, particularly for the smallest trades. Small business proprietors (particularly sole traders) consider taxation a very interesting issue. The proprietors almost always deal with the problem of taxation and carry out a certain part if not

the entire part of the taxation business, working closely with in-house and independent professionals. Many small trades make use of unpaid assistance, but that percentage falls with the rising size of the trade. On the other hand, the percentage of small businesses that hire tax accountants rises with an increase in the size of the trade.

The research resulted in the following recommendations, aimed at reducing the total tax compliance costs for tradesmen, mainly connected with the effectiveness of the tax:

- The introduction of estimated taxation of the income of tradesmen (this option has in the meantime been put into practice) because the costs of compliance incurred by tradesmen are exceptionally high expressed as a percentage of the relevant tax revenue, that is, the low effectiveness of tradesmen's income tax.
- The introduction of a higher threshold for exception (registration threshold) if the tradesmen pay VAT. The reasons for this are high compliance costs expressed as a percentage of tax revenue and VAT's inefficiency and burden to the small business.

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TISKANICA

No. 21, March 2005

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What Are the Compliance Costs of Taxation in Croatia for Individuals?¹

From June 2001 to June 2002, tax compliance costs of almost 57 million kuna, or about 0.03% of GDP were incurred by individual Croatian citizens.

The beginning of the year is the time when many of us who are fortunate enough to have a job and have thus acquired the privilege of paying income tax, collect numerous documents from various institutions (retirement and healthcare institutions, insurance companies, dentists and doctors) in order to be able to claim a refund of the tax paid in the previous year. Apart from hoping that the government (i.e., the Tax Administration) is going to refund to us a certain amount of excess tax, most of us do not know or are not aware that the mere collection of all these documents (required for the refund of tax) creates certain costs.

They constitute a part of the costs above and beyond the actual amount of tax paid that citizens have to bear in order to fulfill the requirements imposed by law and revenue services.

These costs consist of time spent, fees paid, possible payment of tax advisers, the work of unpaid assistants and so on (see Table 1).

Sometimes these costs are lower, but sometimes they are greater than the amount of excess tax refunded.

Therefore, each one of us has to do the math (alone or with the help of friends who are skilled in such matters, or perhaps with tax advisers) and decide whether getting involved in the procedure of claiming an income tax refund is worthwhile.

The Institute of Public Finance made a study using the face-to-face interview method to assess the amount and structure of costs of tax compliance borne by all taxpayers liable to (pay) income tax.

In the research, which covered 300 (randomly selected) subjects (selected by random sampling), we arrived at following conclusions.

The total gross social costs of individual (non-corporate) taxpayers in Croatia are relatively low as compared with other countries, and amount to

¹ This newsletter is based on an article by Blažić, H., 2004. "The Costs of Submitting Income Tax Return", *Financijska teorija i praksa* 3/04, Institut za javne financije. Available from the URL: <http://www.ijf.hr/publikacije/indexpub.html>. The author would like to thank Helena Blažić for the right to use this article.

about 56.9 million kuna, which comes to approximately 0.03% of GDP, 0.8% of the total revenue from income tax, and about 0.9% of the revenue of income tax collected from individuals.

This means that for 100 kuna of tax collected by the Tax Administration, citizens have to bear an additional cost of about one kuna (80 lipa).

A large part of these costs consists of time spent by individuals.

Net costs are higher thanks to cash flow costs, because most taxpayers have to submit a return in order to gain a refund.

This means that the costs have to be increased by the amount of lost interest because, even if individuals can claim the right to a tax refund, the government enjoys the use of their money for some time before returning that surplus (tax that has been overpaid by citizens).

Net costs amount to between 0.05 and 0.07% of GDP, or between 1.3 and 1.8% of the revenue from income tax collected from individual taxpayers. The reasons for income tax compliance costs' being so low is that final tax is collected by withholding and the fact that the period for compliance is short. The average taxpayer takes less than 2 hours a year to perform this duty (1.7 hours, to be exact).

The study showed that the costs of taxing individuals are regressive. This increase in the regressiveness of the compliance costs is mostly related to the increase in the costs of an hour's work and in the overall growth of income.

The structure of the total compliance costs of the income tax of individuals, not including lost interest, is shown in Table 1.

Table 1. Structure of total compliance costs of the taxation of individuals (income tax)

Kind of cost	Structure (%)
Time spent by the person submitting the return	55.93
Paid fees	9.61
Monetary costs apart from paid fees	14.95
Unpaid assistance by officials in the revenue service	0.47
Unpaid assistance by other persons	19.04
Total	100.00

The own time spent constitute the largest part of the costs (56%), followed by unpaid assistance by others (19%) and monetary costs (15%). Taxpayers quite often make use of unpaid help. Here it is important whether the taxpayers fill in their returns themselves or whether they use someone else's assistance, and if they do, what kind of assistance. Unlike the practice in developed countries, taxpayers in Croatia rarely turn to paid expert help (tax advisers, accountants) – only 10% of them do so. However, one can assume that this situation is beginning to change – in 2001, authorized tax advisers have begun their work, whereas before they did not exist. Still, there are not many of them today. Outsourced accountancy provides certain services, but they mainly concentrate on larger business operators, and only rarely on private citizens. Another group of citizens (19%) mostly relies on unpaid help of members of their family, other relatives, friends, and most of all friends and partners at work.

It is interesting that only a third of taxpayers filled in their tax returns themselves. The average time that a taxpayer spent on all activities related to their own tax return, irrespective of whether the taxpayer filled it in himself amounted to 1 hour and 42 minutes. Taxpayers in Slovenia, the only other transition country in which such research has been carried out, took almost the same amount of time (on average, 1.72 hours). But taxpayers who themselves filled in their tax returns spent a little more on average, i.e., 2.15 hours.

Even individuals who engaged other persons to help them fill in their tax returns spent (relatively) quite a lot of time (on average 1.44 hours). The time of other persons whose help was used in filling in the returns consists of the time of persons who are not members of the Tax Administration and the time spent by officials in the revenue service itself. As for the time of unpaid persons, its average came to 0.85 hours, which is much less than the time spent by taxpayers who filled in their returns themselves (2.15 hours). This is directly related to the greater expertise and skill of the persons who helped in filling in the return. This amount is also lower than the average time spent by the taxpayers who used unpaid assistance (help). The difference is explained by other activities that the taxpayer has had to undertake to submit a return.

The number of hours put in by officials of the Tax Administration helping citizens to fill in their

² Klun, M., 2002. "Tax Compliance Costs in Slovenia", *Financijska teorija i praksa* 26 (4), p. 775-792.

returns is of course much lower (0.4 hours). The reason is the greater expertise of officials in the Tax Administration and the fact that the citizens had to fill in most of their forms before bringing it into the office of the Tax Administration. Unpaid assistance of officials in the Tax Administration is in fact part of the administrative costs of taxation, the costs of the Tax Administration. Since it has been shifted to the revenue authorities, it is not part of individual tax compliance costs. In reality, this part is even greater because many persons submitting returns send them in by post, and only some of them are correctly completed. The situation could be improved by more acceptable prices of tax advisers' services. Thus, people without experience in the completion of tax returns and those who do not know anyone willing to help them free of charge, could directly approach a tax adviser, which would result in this cost-shifting being avoided.

It is to be expected that the greatest slice of the pie in the structure of time spent falls due to the actual taxpayer. If we add the time of unpaid assistants, the total time costs make up about three quarters of all the costs of income tax return submissions.

At the end, we provide (some) general and particular recommendations by which the procedure for submitting income tax returns for individuals who are liable to pay income tax might to some extent simplify and improve.

General recommendations:

- The taxation system has to be stable and without constant modifications.
- The tax regulations have to be clear and precise, in order to avoid different interpretations of their application.
- It is necessary for the taxpayer and the tax officials to work together.

Particular recommendations:

- Reduce and simplify the number of forms necessary.
- In order to allow the benefits of the introduction of new relief to outweigh the increased cost of tax compliance and, in general, to be used to the full, it would be a good idea to think about introducing techniques (procedures), which would prevent them being lost in the event of insufficiently large income (tax loss, refunding tax credits, i.e., negative taxes and so on). That is, income tax relief (applied in the tax return in 2001 for the first time) have partially (somewhat) complicated the procedure for submitting the tax return, and most of them cannot be used to the full by taxpayers with low incomes³, anyway.

³ For more about relief in the income tax system, see Newsletter no. 18 "The New Income Tax Law: Impact on the Distribution of the Tax Burden" <http://www.ijf.hr/publikacije/indexpub.html>.

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